

TO: Patty Davis

FROM: Jim Penner, CFA

DATE: April 2, 2014

RE: Stable Value Product/Structure Analysis

The Employee Investment Advisory Committee (EIAC) provides recommendations to the Montana Public Employee Retirement Board for stable value assets in excess of \$250 million owned by current and former Montana state employees. The following is a recap and discussion of stable value as used by Montana's deferred compensation and defined contribution plans. I would like to thank Michael Schlachter, Jerry Hsu and Russ Walker of Wilshire for their valuable input and provision of resources to review.

Stable Value Definition:

A stable value fund is a conservative fund of fixed income securities, much like a money market fund, known for preservation of capital. The stable value product is used by participants who desire to minimize principal risk. Stable value funds invest in fixed-income investments and may also invest in wrap contracts offered by financial institutions. Wrap contracts essentially guarantee a certain principal and interest rate of return, even if the underlying investments decline in value. Current fees for a wrap contract is approximately 20 basis points.

Types of Stable Value Funds:

Separately Managed Accounts – customized investment account designed to meet a specific goal for a single retirement plan.

Commingled Funds – investment account assets combined from more than one retirement plan providing economies of scale.

Guaranteed Investment Contracts (GIC) – account where manager invests in an annuity and the investors in the retirement plan receive guaranteed amount of principal and interest. GIC guarantee is only as good as the credit on the company providing the guarantee.

Synthetic GIC – account invests in a portfolio of fixed income investments “wrapped” in insurance contract(s) that protect the underlying value of the investments. The Montana stable value fund is a synthetic KIC.

Wrap Market Changes

During the market turmoil of 2008-09, stable value funds declined in value (including Montana's fund) but the losses were minimal compared to other markets and the valuations gradually recovered. However, the financial crises resulted in major changes in the fixed income market.

Some stable value wrap providers, predominantly insurance companies, discontinued issuance of insurance wraps for stable value funds. Other insurance companies increased the fees required for an insurance wrap, required funds to have multiple wraps, required a cash buffer in the stable value fund, or some combination of the above.

Montana's wrap provider for many years, Aegon, reacted to the financial crises by requesting the following: that Montana find co-wrap providers so that their share of the Montana fund was significantly reduced, altering the investment criteria for the investment portfolio to be less risky, and initiating a cash buffer to further reduce the chance of the portfolio valuation being less than its cost. In the very near future all these changes to Montana's stable value product will be implemented. The result of these changes is a reduction in the return to stable value participants.

Alternatives:

EIAC is at a crossroad of accepting the changing interest rate environment and execution of stable value or changing the investment alternative available to participants who seek preservation of capital with a reasonable yield. The most likely alternatives include a short-term bond fund or a tips fund. Neither of the alternatives provide any assurance of a positive daily earnings yield and in fact it is almost a given that at some time these products would generate a negative crediting rate.

TIPS Fund – treasury inflation-protected securities are not generally regarded as competing with stable value funds by the stable value fund industry because their average duration is relatively long. Recently, Transamerica conducted a study that called this view into question. The study indicated that under certain conditions the duration of a TIPS fund might decline to the duration of a competing stable value fund. However, Transamerica ultimately decided to continue to monitor the duration of tips funds to ensure that TIPS funds are not approaching the duration of competing stable value funds.

Short-term Bond Fund – a bond fund typically with a 1-3 years average maturity structure and a short duration. The three short-term bond indices that were reviewed included Barclays Aggregate U.S. 1-3 Index; Barclays U.S. Government 1-3 Index; and Barclays U.S. Government/Credit 1-3 Index.

Analysis:

The stable value wrap product Montana uses is experiencing a declining crediting rate as legacy investments purchased during a higher interest rate time mature and are replaced by today's significantly lower interest rate investments. This is happening to all users of stable value wrapped products. Given the duration of low interest rates and general visibility of the low rate phenomenon for money market funds and certificates of deposits most participants understand the limitations on program sponsors.

Wilshire ran index returns for eight different fixed income indices including three short-term bond fund types dating back as far as 30 years testing for periods of negative returns. As expected, the higher maturity bond funds generated negative returns more often and were more negative than the three short-term bond funds. More importantly, even the short-term bond fund indices listed above all had negative returns on six separate occasions and during a second time period the return was so low that it would not cover the cost of investment management and custody costs. (30 basis points) The most recent period of negative returns came in the second quarter of 2013 when interest rates soared on the Fed's announcement it was going to taper its quantitative easing. The worst negative returns were generated in 1980 when the Volcker led Fed squashed inflation by boosting interest rates to a double digit level.

The second quarter stable value crediting rate of 1.87% is the same as the crediting rate for the previous quarter. A steepening yield curve is helping level out the return for stable value though there is no assurance that further declines could happen in future quarters. Initiating a bond fund investment when interest rates are rising is a poor choice for participants as it risks principal loss for the investor.

Conclusion:

The TIPS product is unproven in terms of being a stable value substitute and short-term bond funds, though usually competitive on a return basis with the stable value product, are certain to have periods when the investment return is negative and the participants will lose principal value. Consequently, there is a major difference between the wrapped stable value product and the unwrapped short-term bond fund with respect to preservation of capital. The approximately 20 basis point fee for a wrap guarantee reduces the advantages of the stable value product but does not eliminate the value of having principal protected. Therefore, this writer does not see a short-term bond fund as a suitable substitute for a wrapped stable value product.

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